

Appreciating the Depreciation of Intangible Assets

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Section 167(a) of the Internal Revenue Code¹ allows as a deduction for depreciation² a reasonable allowance for the exhaustion and wear and tear, including obsolescence, of property used in a trade or business or of property held for the production of income.³ Although the Code did not specifically address the depreciation of intangible assets in the past,⁴ the treasury regulations provided some guidance.⁵ The regulations allowed depreciation for intangible assets if they were used in a business or in the

¹ I.R.C. § 167(a) (West Supp. 1994). References herein to the "Code" or "section" are to the Internal Revenue Code.

² Although the term "amortization" should be used for intangible assets, the Code, regulations, and court decisions generally have used the term "depreciation."

³ Section 167 states:

(a) General rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

I.R.C. § 167(a) (West Supp. 1994).

⁴ Intangible assets are those assets that lack a physical nature, but are instead generally represented by physical evidence such as contracts and stock certificates. Intangible assets allow the physical assets of a business to produce income, rather than having any distinct value in themselves. 5 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 23A.124 (1990).

⁵ Treasury Regulation § 1.167(a)-3 established the general rule regarding the deductibility of intangibles:

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

production of income for a limited period that can be estimated with reasonable certainty.⁶ Conversely, if an asset has a useful life that is not limited, it is not depreciable.⁷ The regulations state that depreciation deductions are not allowable for goodwill.⁸ Courts have had to confront the issue of determining whether an asset used in the production of income has a limited useful life or whether it is simply a part of the goodwill of the business.

The dispute has focused on whether customer-based intangible assets,⁹ such as customer or subscriber lists, insurance expirations,¹⁰ and core bank deposits¹¹ are depreciable.¹² Taxpayers have consistently argued that these assets are depreciable.¹³ The Internal Revenue Service has adopted the position that because the value of these assets is dependent upon the voluntary patronage of customers, it is indistinguishable from goodwill and not depreciable.¹⁴

Treas. Reg. § 1.167(a)-3 (1960).

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ Customer-based intangibles can be described as a percentage of market share, and any other value that results from the future provision of goods or services because of relationships with customers in the ordinary course of business. 137 CONG. REC. E2706, 2707 (daily ed. July 25, 1991) (statement of Rep. Rostenkowski).

¹⁰ Insurance expirations are lists that include information about currently insured individuals, the dates on which their policies will expire, and the amount of their insurance coverage. Rev. Rul. 74-456, 1974-2 C.B. 65. This information is used by insurance agents to contact individuals when they are in need of new coverage.

¹¹ Core bank deposits represent the income expected to be derived from accounts presently held by the acquired bank. *Citizens & S. Corp. v. Commissioner* 91 T.C. 463, 465 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

¹² David G. Jaeger, *Supreme Court Decides Newark Morning Ledger Co.*, 71 TAXES 406, 406 (1993).

¹³ *Id.*; *see, e.g.*, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993) (regarding the depreciation of newspaper subscriber lists); *Commissioner v. Seaboard Fin. Co.*, 367 F.2d 646 (9th Cir. 1966) (considering depreciation of premium paid for purchase of small loan company); *AmSouth Bancorporation v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988) (discussing the depreciation of core bank deposits); *General Television, Inc. v. United States*, 449 F. Supp. 609 (D. Minn. 1978), *aff'd per curiam*, 598 F.2d 1148 (8th Cir. 1979) (involving the depreciation of cable television subscriber lists); *Richard S. Miller & Sons Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976) (discussing the depreciation of insurance expirations).

¹⁴ Jaeger, *supra* note 12, at 406; *see, e.g.*, *Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987) (examining IRS argument that purchased subscription

In critically examining the controversy surrounding the depreciation of intangible assets, Part I of this Note explores the nature of goodwill. Part II examines the tradition behind denying depreciation deductions for goodwill. Part III of this Note analyzes the universally followed two-part test set out in *Houston Chronicle Publishing Co. v. United States*¹⁵ for determining when intangible assets are depreciable. Part IV evaluates the varying applications of the *Houston Chronicle* test, which have resulted in apparent inconsistencies and a corresponding circuit split. Part V summarizes the reasoning of both the majority and the dissent in the Supreme Court's attempt to resolve this split through its decision in *Newark Morning Ledger Co. v. United States*.¹⁶ Part VI of this Note evaluates the effects of the *Newark Morning Ledger* decision. Part VII reviews and evaluates section 197,¹⁷ Congress' response to *Newark Morning Ledger*.

I. THE NATURE OF GOODWILL

Although neither the Code nor the regulations defined "goodwill,"¹⁸ the revenue rulings provide some insight. Under revenue ruling 59-60¹⁹ goodwill is "the excess of net earnings over and above a fair return on the net tangible assets."²⁰ Although this definition provides a good general description of goodwill, it tells us little more than that goodwill is simply the sum of intangibles of a business.

lists are inseparable from goodwill); *Imperial News Co. v. United States*, 576 F. Supp. 865, 867 (E.D.N.Y. 1983), *aff'd*, 742 F.2d 1434 (2d Cir. 1984) (discussing IRS claim that the probability of continued patronage that a magazine distributor acquired when it purchased other distributors had an indeterminate useful life); *Colorado Nat'l Bankshares v. Commissioner*, 60 T.C.M. 771, 787-90 (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993) (evaluating IRS position that core bank deposits lack an ascertainable value); *Citizens & S. Corp. v. Commissioner*, 91 T.C. 463, 479-500 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (considering IRS argument that purchased subscription lists are inseparable from goodwill).

¹⁵ *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1974), *cert. denied*, 414 U.S. 1129 (1974).

¹⁶ 113 S. Ct. 1670 (1993).

¹⁷ I.R.C. § 197 (West Supp. 1994).

¹⁸ See Lawrence M. Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 TAXES 930, 931-32 (1979) (defining goodwill).

¹⁹ Rev. Rul. 59-60, 1959-1 C.B. 237, 241.

²⁰ *Id.*

The traditional definition of goodwill, articulated by Justice Story, is more illuminating.

[G]oodwil [sic] may be properly enough described to be the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities, or prejudices.²¹

Justice Story's definition illustrates that factors such as the successful operation of a business for a long period of time, the prestige of the business, and its reputation in the community are all components of goodwill.

In order to completely appreciate the intangible nature of goodwill, it should be contrasted with tangible items such as trademarks, tradenames, patents, and copyrights, all of which are composed, to some extent, of tangible items.²² Goodwill is distinguishable from going concern value.²³ Intangible factors, such as a long course of successful business dealings, a prominent location, and a reputation for quality service, are merged into the tangible items of trademark and tradename.²⁴ Consequently, the intangible items that compose tangible trademarks and tradenames must be severed from goodwill in order to arrive at an accurate valuation of goodwill.²⁵

Goodwill that is the subject of a purchase and a sale is the result of the antecedent business relations created by the seller and his former customers.²⁶ For tax purposes, goodwill is characterized as the transfer of an expectancy of continued earnings that exceeds the fair return produced by only the tangible assets of the business.²⁷ Because goodwill must be capable of being conveyed to the buyer, neither the personal qualifications

²¹ JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 99 (1841); *see* Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1893); Red Wing Malting Co. v. Willcuts, 8 F.2d 180, 182 (D. Minn. 1925), *aff'd*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927).

²² 15 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 59.58 (1994).

²³ 5 *id.* § 23A.131 (1990).

²⁴ 15 *id.* § 59.58 (1994).

²⁵ *Id.*

²⁶ 15 *id.* § 59.59.

²⁷ *Id.*

of the owner, nor an unusual demand for a product of the business constitute goodwill.²⁸

Shorthand definitions of goodwill focus on the expectancy of the continued patronage of customers. Goodwill is characterized by the tendency of old customers to return to a familiar place of business.²⁹ As one commentator has suggested, the “essence of goodwill is a preexisting business relationship, based on a continuous course of dealing that may be expected to continue indefinitely and is transferable to the buyer [of the business].”³⁰

II. THE DENIAL OF THE DEPRECIATION DEDUCTION FOR GOODWILL

The historical basis for the law prohibiting the depreciation of goodwill began with the Eighth Circuit’s decision in *Red Wing Malting Co. v. Willcuts*.³¹ In *Red Wing Malting*, the taxpayer, a barley malt manufacturer, had its market destroyed by prohibition and attempted to deduct the obsolescence of goodwill on its 1918 tax return.³² The Revenue Act of 1918³³ “limit[ed] the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business.”³⁴ Even assuming that goodwill was distinct from tangible property, the Eighth Circuit Court of Appeals held that because goodwill was not the type of property that wears out or has an ascertainable life, it was not depreciable under the 1918 Revenue Act.³⁵

²⁸ *Id.*

²⁹ *See, e.g.,* *Karan v. Commissioner*, 319 F.2d 303, 306 (7th Cir. 1963) (noting that goodwill has been defined as the probability that “‘old customers will resort to the old place’ without contractual compulsion”) (quoting *Brooks v. Commissioner*, 36 T.C. 1128, 1133 (1961)); *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962) (describing goodwill as a long-standing relationship with a satisfied clientele); *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962) (stating that the “essence of good will is the expectancy of continued patronage, for whatever reason”); *Burke v. Canfield*, 121 F.2d 877, 880 (D.C. Cir. 1941) (defining goodwill as essentially the tendency of customers to return for trade to those with whom they are accustomed to dealing); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 233 (1975) (stating that the essence of goodwill is a pre-existing business relationship).

³⁰ *Dubin*, *supra* note 18, at 931.

³¹ 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927).

³² *Id.* at 627.

³³ Revenue Act of 1918, ch. 18, § 234(a)(7), 40 Stat. 1057, 1078 (1919).

³⁴ *Red Wing Malting Co.*, 15 F.2d at 633.

³⁵ *Id.*

In *Haberle Crystal Springs Brewing Co. v. Clarke*, the Second Circuit Court of Appeals addressed facts almost identical to those in *Red Wing Malting*, but held that goodwill was depreciable under the 1918 Revenue Act.³⁶ The court viewed goodwill as an owner's privilege of continuing to deal with established customers, noting that goodwill can only exist when it is connected to an ongoing business.³⁷ The Prohibition legislation that cut short the use of tangibles in businesses that manufactured or sold alcohol also necessarily limited the life of goodwill.³⁸ Goodwill was subject to obsolescence and thus depreciable.³⁹

Because of the circuit split, the Supreme Court granted certiorari.⁴⁰ In a short, sharply worded opinion, the Court prohibited the depreciation of goodwill.⁴¹ The Court based its decision on congressional intent⁴² rather than on sound accounting principles.

The constitutional amendment prohibiting alcohol was ratified by the states prior to the time that the Revenue Act of 1918 was passed by Congress.⁴³ The Court reasoned that congressional intent in passing the Revenue Act could not have been to provide tax abatements, in the form of depreciation for goodwill, to businesses that were being extinguished because they constituted a noxious use.⁴⁴ It is on these tenuous grounds that the denial of the depreciation deduction for goodwill is based.

Cases subsequent to *Clarke* denied depreciation for goodwill on the basis of the "mass-asset" rule.⁴⁵ Courts have reasoned that when a going business is purchased the purchase price paid for the customers' contracts, taken in the aggregate, constitutes an intangible capital asset because these

³⁶ *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F.2d 219, 222 (2d Cir. 1929), *rev'd*, 280 U.S. 384 (1930).

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384, 385 (1930).

⁴¹ *Id.* at 386-87.

⁴² *Id.* at 387.

⁴³ *Id.*

⁴⁴ *Id.* at 386-87.

⁴⁵ See *Golden State Towel & Linen Serv. v. United States*, 373 F.2d 938, 944 (Ct. Cl. 1967) (reasoning that a purchased customer list is an indivisible business property because the whole is equal to the sum of its fluctuating parts at any given time); *General Television, Inc. v. United States*, 449 F. Supp. 609, 611-12 (D. Minn. 1978), *aff'd per curiam*, 598 F.2d 1148 (8th Cir. 1979) (concluding that cable subscriber lists that were actually customer structures with the expectancy of continued patronage rather than lists of potential customers constituted an indivisible nondepreciable asset).

contracts are self-regenerating.⁴⁶ Under this rule, goodwill is characterized as a self-regenerating asset; the expiring components (customers) are replaced through time so that the asset's value remains relatively constant.⁴⁷ Courts that have adhered to the mass-asset rule have generally held that customer-based intangibles, such as subscription lists, are so intertwined with goodwill (if not equivalent to goodwill itself) that they are per se nondepreciable.⁴⁸

III. *HOUSTON CHRONICLE* AND ITS PROGENY

In *Houston Chronicle Publishing Co. v. United States*,⁴⁹ the Fifth Circuit explicitly rejected the mass-asset rule in favor of a two-part test for determining the depreciability of intangibles.⁵⁰ In *Houston Chronicle*, the taxpayer had acquired all of the assets of a competing newspaper, including subscription lists.⁵¹ A valuation study established the value of the subscription lists by estimating the number of subscribers that would have become *Houston Chronicle* subscribers on the closing of the former paper,

⁴⁶ Mark Wertlieb et al., *The Amortization of Purchased Intangible Assets*, 1993 TAX ADVISER 583, 584.

⁴⁷ *Id.*

⁴⁸ This general approach was reflected in *Golden State Towel & Linen Serv. v. United States*:

[A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.

373 F.2d 938, 944 (Ct. Cl. 1967).

⁴⁹ *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1974), *cert. denied*, 414 U.S. 1129 (1974).

⁵⁰ *Id.* at 1249–50.

⁵¹ *Id.* at 1243.

multiplied by the average cost of obtaining a new subscriber.⁵² Because the taxpayer had no intentions of continuing publication of the purchased newspaper, the court stated that the subscription lists were not self-regenerating.⁵³ The only value of the lists to the taxpayer was to provide names and addresses of potential subscribers.⁵⁴

Although the Service argued that the lists were not depreciable as a matter of law because they were inextricably linked to goodwill, the court rejected this argument.⁵⁵ The court held that the taxpayers were entitled to depreciation deductions upon satisfaction of a two-part test.⁵⁶ First, the taxpayer must prove that the intangible asset has an ascertainable value that is separate and distinct from goodwill.⁵⁷ Second, the asset must have a limited useful life whose length can be determined with reasonable certainty.⁵⁸

In response to the Fifth Circuit's *Houston Chronicle* decision, the Service articulated its official position regarding the depreciation of intangible assets in Revenue Ruling 74-456.⁵⁹ In this ruling, the Service stated that the depreciability of intangible assets such as customer and subscription lists is a factual test, met only if the two-part *Houston Chronicle* test is satisfied.⁶⁰ Generally, however, customer-based intangibles are not depreciable because they are either in the nature of goodwill or have lives of indeterminate length.⁶¹

As a consequence of both the Fifth Circuit's *Houston Chronicle* decision and the Service's subsequent Revenue Ruling, the test for the depreciability of intangible customer-based assets was reduced to a factual inquiry as to whether the asset: (1) had an ascertainable value separate and distinct from goodwill, and (2) had a limited useful life that could be computed with a reasonable degree of accuracy. Although many courts have applied this test, they have reached different outcomes, depending on both how they have defined "goodwill" and which aspects of the two-part test they have emphasized.⁶²

⁵² *Id.* at 1243-44.

⁵³ *Id.* at 1244.

⁵⁴ *Id.*

⁵⁵ *Id.* at 1249-50.

⁵⁶ *Id.* at 1250.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Rev. Rul. 74-456, 1974-2 C.B. 65.

⁶⁰ *Id.* at 66.

⁶¹ *Id.*

⁶² Jaeger, *supra* note 12, at 408.

IV. THE CIRCUIT SPLIT IN THE APPLICATION OF THE *HOUSTON CHRONICLE* TEST

The application of the *Houston Chronicle* test to different fact patterns illustrates the varying results that courts have reached. In *Citizens & Southern Corp. v. Commissioner*,⁶³ the taxpayer acquired nine banks, and sought to depreciate the banks' deposit bases.⁶⁴ Because these deposit bases had a definite value and their useful lives could be ascertained with reasonable accuracy, the taxpayer argued that the deposit bases were depreciable.⁶⁵ The Tax Court determined that studies done by the taxpayer, which estimated the percentage of accounts that would close over a given period of time, established the useful life of the deposits.⁶⁶ Under the *Houston Chronicle* test, the taxpayer had proven that the deposit base had an ascertainable cost separate and distinct from the goodwill of the acquired banks.⁶⁷

The Tax Court reached the same result in *Colorado National Bankshares, Inc. v. Commissioner*.⁶⁸ The court specifically held that core bank deposits could be valued directly and had limited lives that were measurable with a reasonable degree of accuracy.⁶⁹ Consequently, the assets were separate from goodwill,⁷⁰ entitling the taxpayer to depreciate them.

In contrast to the holdings in *Citizens & Southern Corp.* and *Colorado National Bankshares*, other courts, under similar facts, have disallowed depreciations for core bank deposits. In *AmSouth Bancorporation v. United States*,⁷¹ AmSouth Bancorporation acquired the assets and assumed the liabilities of the Bank of East Alabama (BEA).⁷² In applying the traditional definition of goodwill (the expectancy of continued patronage), the district court held that BEA had goodwill and that the plaintiff had not met its burden of proving that the customer deposit base had a value separate and

⁶³ 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

⁶⁴ *Id.* at 464. "Deposit base" describes "the intangible asset that arises in a purchase transaction representing the present value of the future stream of income to be derived from employing the purchased core deposits of a bank." *Id.* at 465.

⁶⁵ *Id.* at 498-505.

⁶⁶ *Id.* at 505.

⁶⁷ *Id.*

⁶⁸ 60 T.C.M. (CCH) 771 (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993).

⁶⁹ *Id.* at 789.

⁷⁰ *Id.*

⁷¹ 681 F. Supp. 698 (N.D. Ala. 1988).

⁷² *Id.* at 699.

distinct from the goodwill of BEA.⁷³ The deposits of BEA's customers served as the point of contact with its customers; therefore, the relationship was inseparable from goodwill.⁷⁴

In *Banc One Corp. v. Commissioner*,⁷⁵ the court examined a fact pattern almost identical to that presented in *Citizens & Southern Corp.* The court employed a residual definition of goodwill: Goodwill is the value that remains after accounting for assets with ascertainable values and determinable useful lives.⁷⁶ Consequently, the court held that the taxpayer was not entitled to a depreciation deduction for the deposit bases.⁷⁷

The controversy regarding the depreciation of intangible assets is not confined to bank deposits. In *Newark Morning Ledger Co. v. United States*,⁷⁸ the taxpayer sought to depreciate a portion of the purchase price of eight newspapers as allocated to an intangible asset called paid subscribers.⁷⁹ After determining that the taxpayer had demonstrated that paid subscribers had both a useful life and a value separate and distinct from goodwill, the District Court of New Jersey held that the taxpayer was entitled to an amortization deduction.⁸⁰ The Third Circuit Court of Appeals reversed, however, holding that some intangibles "notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable."⁸¹ The court stated that the taxpayer had not satisfied its burden of proving that paid subscribers were separate and distinct from goodwill.⁸²

In *Donrey, Inc. v. United States*,⁸³ the Eighth Circuit was faced with almost identical facts to those in *Newark Morning Ledger*, but reached a contrary result. The taxpayer sought to depreciate the subscription list of a newspaper that it had purchased.⁸⁴ The Service argued that because the purchased subscription list was inseparable from goodwill, it was not depreciable as a matter of law.⁸⁵ The Eighth Circuit Court of Appeals

⁷³ *Id.* at 719.

⁷⁴ *Id.* at 719-20.

⁷⁵ 84 T.C. 476 (1985), *aff'd*, 815 F.2d 75 (6th Cir. 1987).

⁷⁶ *Id.* at 502.

⁷⁷ *Id.*

⁷⁸ 734 F. Supp. 176 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

⁷⁹ *Id.* at 177.

⁸⁰ *Id.* at 180-85.

⁸¹ 945 F.2d at 568.

⁸² *Id.*

⁸³ 809 F.2d 534 (8th Cir. 1987).

⁸⁴ *Id.* at 535.

⁸⁵ *Id.*

rejected the Service's argument and instead held that the subscription list was depreciable because it had an ascertainable value and a determinable useful life.⁸⁶

One central point should be apparent from the contrasting positions reached by courts regarding the depreciation of intangibles. Because no standard or generally accepted definition of "goodwill" exists, courts have applied different definitions, and correspondingly, have reached different results. All of these courts have attempted to draw the fine, and perhaps artificial, line between goodwill and other intangibles, but instead have created confusion, inconsistency, and uncertainty.

V. THE SUPREME COURT'S DECISION IN *NEWARK MORNING LEDGER*

The split among the circuits regarding the application of the two-part *Houston Chronicle* test to customer-based intangibles was resolved in *Newark Morning Ledger Co. v. United States*.⁸⁷ In a 5-4 decision, the Supreme Court reversed the Third Circuit and held for the taxpayer.⁸⁸ The majority⁸⁹ began its analysis by characterizing goodwill as "the expectancy of continued patronage."⁹⁰ Although this definition provides a good shorthand way in which to view goodwill, the court noted that this definition tells us nothing about whether an asset is depreciable.⁹¹ The value of every intangible asset is related, to some extent, to the expectation that customers will continue their patronage.⁹² Hence, the cornerstone of the Court's decision did not rest on its characterization of goodwill.

The majority held that if a taxpayer can prove with reasonable accuracy that an asset which will be used in a business has value that wastes over an ascertainable period of time, the asset is depreciable under section 167.⁹³

⁸⁶ *Id.* at 537.

⁸⁷ 113 S. Ct. 1670 (1993), *rev'g*, 945 F.2d 555 (3d Cir. 1991). For a discussion of the factual background and the lower court decisions in this case, see *supra* text accompanying notes 78-82.

⁸⁸ *Id.* at 1683.

⁸⁹ Justice Blackmun, the author of the majority opinion, was joined by Justices Stevens, O'Connor, Kennedy, and Thomas. *Id.* at 1671.

⁹⁰ *Id.* at 1675 (quoting *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962)).

⁹¹ *Id.* at 1676 n.9.

⁹² *Id.* at 1675-76.

⁹³ *Id.* at 1680-81. Justice Blackmun stated that the majority opinion does not alter the prohibition in Treasury Regulation § 1.167(a)-3 against depreciating goodwill. *Id.* at 1680 n.13. Instead, the Court interpreted the Regulation so that any asset that has a limited useful life and an ascertainable value is by definition not goodwill. *Id.* The

The fact that the asset's value may be related to the expectancy of continued patronage is not relevant.⁹⁴ The key inquiry is whether the asset can be valued and whether that value diminishes through time.⁹⁵ The Court downplayed the first prong of the *Houston Chronicle* test in favor of a more analytic approach that focused on the valuation of the asset, not whether it was separable from goodwill.

In discussing the appropriate burden of proof for the taxpayer in attempting to depreciate intangibles, the Court noted that the taxpayer's burden will be a high one, which will often be too difficult to bear.⁹⁶ The taxpayer's burden in the present case was substantially lightened by the fact that the government agreed to the stipulated useful lives assigned by the taxpayer's experts to the paid subscribers.⁹⁷ The taxpayer successfully argued that the assets in question were not self-regenerating, but waste over time because the subscriptions are canceled over a relatively predictable period.⁹⁸ Using generally accepted statistical principles, the taxpayer was able to prove that the asset consisted of identifiable components, subscriptions, each of which had lives of limited duration.⁹⁹

Regarding the issue of valuation, the taxpayer argued that the fair market value of the paid subscriber lists was \$67.8 million.¹⁰⁰ In applying the income approach to valuing this asset, the taxpayer "comput[ed] the present value of the after-tax subscription revenues to be derived from the 'paid subscribers,' less the cost of collecting those revenues, and adding the present value of the tax savings resulting from the depreciation of the 'paid subscribers.'"¹⁰¹ The court rejected the government's approach to valuation because the government merely took as its value the cost of generating a similar list.¹⁰² Because the list of subscribers involved herein had subscribed to the newspaper over a long period of time, they represented a predictable source of future revenue.¹⁰³

Court limited its inquiry to the facts with which it was presented to hold that the "paid subscribers" list was depreciable. *Id.*

⁹⁴ *Id.* at 1680-81.

⁹⁵ *Id.* at 1680.

⁹⁶ *Id.* at 1681.

⁹⁷ *Id.* In fact, the Court noted that the government chose to rest its entire case on legal arguments rather than challenging the evidence the taxpayer had produced. *Id.* at 1681-82 n.14. In short, the Court stated that the government lost this case at trial. *Id.*

⁹⁸ *Id.* at 1681.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 1682.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

In an opinion authored by Justice Souter,¹⁰⁴ the dissenting Justices argued that under the traditional definition of goodwill as “the expectation of continued patronage,” the alleged asset that the taxpayer deemed “paid subscribers” was simply the goodwill associated with these subscribers.¹⁰⁵ Justice Souter argued that the majority had incorrectly viewed goodwill as the residual asset whose value is determined by the business’s purchase price minus the identifiable assets that have determinable lives.¹⁰⁶ The majority had reduced the concept of goodwill to nothing more than an “accounting leftover,” according to the dissenting Justices.¹⁰⁷

The dissent also criticized the majority’s arguments because the evidence presented by the taxpayer regarding the useful lives of the paid subscribers was vulnerable to attack.¹⁰⁸ The flaws in the taxpayer’s methods prevented the useful lives from being measured with any degree of certainty.¹⁰⁹ The insufficiency of the evidence alone should have been enough to deny the taxpayer’s depreciation deduction.¹¹⁰

VI. THE EFFECTS OF *NEWARK MORNING LEDGER*

Although the Supreme Court’s decision in *Newark Morning Ledger* may be interpreted as standing for the proposition that all customer-based intangibles, and more specifically customer lists, are depreciable, it is unlikely that this case would have had much precedential value. The narrow 5-4 decision, the Service’s error in failing to contest the taxpayer’s expert evidence, and the Service’s stipulation to the estimates of the useful lives of the “paid subscribers” of each newspaper, lead one to believe that if the Service had chosen a different litigation strategy, a contrary result may have been reached.¹¹¹

¹⁰⁴ Justice Souter was joined by Chief Justice Rehnquist and Justices White and Scalia. *Id.* at 1683.

¹⁰⁵ *Id.* at 1684.

¹⁰⁶ *Id.* at 1684-85.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 1686.

¹⁰⁹ *Id.* at 1686-89.

¹¹⁰ *Id.* at 1686.

¹¹¹ George Brode, Jr., *Structuring Taxable Acquisitions of Intangibles Under Section 197*, 60 TAX NOTES 1011, 1016 (1993).

The Court's discussion of the application of the mass-asset rule is vulnerable to criticism.¹¹² According to the majority, the mass-asset rule "provides that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole."¹¹³ The mass-asset rule does not permit the depreciation of certain customer-based intangibles because they are self-regenerating assets.¹¹⁴

The majority stated that the mass-asset rule "continues to guide the decisions of the Tax Court with respect to certain intangible assets."¹¹⁵ The court cited *Ithaca Industries, Inc. v. Commissioner*¹¹⁶ as an example that the mass-asset rule retains its vitality.¹¹⁷ The majority opinion may be read as requiring the taxpayer, in order to meet its burden of proof, to establish why the mass-asset rule does not apply to intangible assets other than those that are customer-based.¹¹⁸ Consequently, the decision may have an adverse impact on those taxpayers who seek to depreciate non-customer-based intangible assets.

By rejecting the traditional definition of goodwill, the Court shifted the focus from distinguishing between intangible assets and goodwill to valuing the assets. Recall that the key inquiry is whether assets can be valued and whether that value diminishes over time.¹¹⁹ The implication of this approach is that asset valuation and useful life, not the nature of the intangible asset, are controlling.¹²⁰

¹¹² George L. Middleton, Jr. & Christian M. McBurney, *The Morning After Newark Morning Ledger: What Should Taxpayers Do Now?*, 59 TAX NOTES 817, 821 (1993).

¹¹³ *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1676 (1993).

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 1677.

¹¹⁶ 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994). In this case, the taxpayer sought to depreciate the value allocated to the trained work force of a purchased going concern over the length of time each employee remained with the purchasing company. *Id.* at 261. The court emphasized that whether an assembled work force is an intangible asset with an ascertainable value and a limited useful life separate from goodwill is a question of fact. *Id.* at 263-64. The court held that the mass-asset rule applied to prohibit the depreciation of the cost of acquiring the assembled work force. *Id.* at 267.

¹¹⁷ *Newark Morning Ledger*, 113 S. Ct. at 1677-78.

¹¹⁸ Middleton, *supra* note 112, at 821.

¹¹⁹ *Newark Morning Ledger*, 113 S. Ct. at 1680.

¹²⁰ *See id.*

The result is that rather than settling the dispute, the Supreme Court may merely have shifted its focus. The Court applied the *Houston Chronicle* approach with one exception.¹²¹ By implicitly rejecting the first prong of the *Houston Chronicle* test, the court indicated that the ascertainable value of the asset need not be shown to be separate and distinct from goodwill.

The Court was left at the mercy of the valuation experts, because it focused on the value of the asset. So long as an intangible asset beyond the identifiable tangible assets of a business can be shown to have value which wastes over time, depreciation of the intangible asset is apparently permissible.

The *Newark Morning Ledger* decision also has a number of implications on tax policy. First, the decision provides some insight into the appropriate valuation method for customer-based intangibles.¹²² The Court rejected the cost method of valuation¹²³ in favor of the income method¹²⁴ as the appropriate means for determining the value of an intangible asset.¹²⁵ The approval of the income valuation method is a benefit for taxpayers because it permits much larger depreciation deductions than the cost method.¹²⁶ In *Newark Morning Ledger*, for example, the income method produced a value of \$67 million for the subscriber lists, while the cost method produced a value of only \$3 million.¹²⁷

Second, the Service could get more aggressive with certain taxpayers by reducing the basis of their intangible assets in the year in which they are sold, by the amount of allowable depreciation not actually claimed by taxpayers in preceding years.¹²⁸ Under section 1016(a)(2) of the Code, the amount of a taxpayer's basis may be reduced by the amount of depreciation allowed or allowable in prior years.¹²⁹ Depreciation "allowable" pertains

¹²¹ For a more detailed discussion of the *Houston Chronicle* test, see *supra* text accompanying notes 49–58.

¹²² Jaeger, *supra* note 12, at 413.

¹²³ The cost method for valuing an intangible asset determines the cost of creating a similar intangible asset. See *Newark Morning Ledger*, 113 S. Ct. at 1682.

¹²⁴ The income method for valuing an intangible asset determines the present value of the revenues to be derived from the asset, taking into consideration the cost of collecting those revenues and taxes. *Id.*

¹²⁵ Jaeger, *supra* note 12, at 413.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ Middleton, *supra* note 112, at 823.

¹²⁹ *Id.*

to depreciation that should have been allowed in prior taxable years on the basis of facts that should have been reasonably known at that time.¹³⁰

Although the *Newark Morning Ledger* decision provided some guidance to taxpayers regarding the depreciation of intangible assets, it is far from decisive on the issue. Instead of providing a principled distinction between intangible assets and goodwill, the Court permitted the resolution of depreciation disputes to remain contingent upon the particular facts of each case. Rather than completely resolving the issue, the Court's decision encouraged taxpayers to pursue creative valuation techniques and employ better experts, potentially leading to increased litigation. The decision sent a message to the Service that it should more aggressively contest the valuation techniques of taxpayers' experts, or litigate depreciation deductions that should have been taken by taxpayers in prior years, to work a reduction in basis and increase revenue.

VII. THE LEGISLATIVE RESPONSE

Because of the uncertainty that remained after the *Newark Morning Ledger* decision, Congress took legislative action on August 10, 1993. Section 13261(a) of the Omnibus Budget Reconciliation Act of 1993 enacted new section 197 of the Internal Revenue Code, which changes the tax treatment of intangible assets.¹³¹ As a result, many of the unresolved issues that remained after *Newark Morning Ledger* have been clarified.

Section 197 permits the cost of most intangible assets acquired after the date of enactment to be amortized over a fifteen-year period.¹³² The most

¹³⁰ Treas. Reg. § 1.1016-3(a)(1)(ii) (1960).

¹³¹ Pub. L. No. 103-66, § 13261(a), 107 Stat. 312, 532 (1993).

¹³² I.R.C. § 197. This Code section provides, in relevant part:

SEC. 197. AMORTIZATION OF GOODWILL AND CERTAIN OTHER INTANGIBLES

(a) GENERAL RULE.—A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(b) NO OTHER DEPRECIATION OR AMORTIZATION DEDUCTION ALLOWABLE.—Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

(c) AMORTIZABLE SECTION 197 INTANGIBLE. For purposes of this section—

important aspect of new section 197 is that it includes acquired goodwill and going concern value as amortizable intangible assets.¹³³ Premiums that

(1) IN GENERAL.—Except as otherwise provided in this section, the term “amortizable section 197 intangible” means any section 197 intangible—

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

(2) EXCLUSION OF SELF-CREATED INTANGIBLES, etc.—The term “amortizable section 197 intangible” shall not include any section 197 intangible—

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

I.R.C. § 197 (West Supp. 1994).

¹³³ I.R.C. § 197. Subsection (d) provides, in relevant part:

(d) Section 197 intangible.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the term section 197 “intangible” means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

had been paid in taxable acquisitions over the fair market value of the target's tangible assets that previously could not be written off can now be depreciated over a fifteen-year period.¹³⁴ Disputes will no longer turn on a factual test that permits apparent inconsistencies. The depreciation of intangibles may now be simpler and allow for more predictable results.¹³⁵

The revision will prevent the squandering of financial resources on litigation costs.¹³⁶ Under the facts and circumstances test, those with greater financial resources to hire better valuation experts were more likely to prevail than those who had fewer resources.¹³⁷ The government will no longer be forced to hire costly valuation experts to compete with private corporations. Insofar as revised section 197 has removed the dispute from a facts and circumstances test, it may also have leveled the playing field so that taxpayers in similar situations are treated equally.

A major revision in the Code will usually have significant ramifications for both taxpayers and the courts, and the enactment of new section 197 is no exception. Because of the enactment of the revision, the Service is being forced to settle pre-1993 cases.¹³⁸ In fact, the Conference Agreement¹³⁹ strongly urged the Service to settle these cases, stating:

The severe backlog of cases in audit and litigation is a matter of great concern to the conferees; and any principles established in such cases will no longer have precedential value due to the provision contained in the conference agreement. Therefore, the conferees urge the Internal Revenue Service . . . to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item

I.R.C. § 197 (West Supp. 1994).

¹³⁴ Brode, *supra* note 111, at 1017.

¹³⁵ See Marc D. Levy et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N 4, 8 (1993).

¹³⁶ Middleton, *supra* note 112, at 826.

¹³⁷ See *id.* at 827.

¹³⁸ Wertlieb, *supra* note 46, at 589-90.

¹³⁹ H.R. CONF. REP. NO. 103-213, 103rd Cong., 1st Sess. 696 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1385.

controversies in an expedited and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers.¹⁴⁰

Under prior law, the Service is challenging approximately \$8 billion of amortization deductions.¹⁴¹ At a 34% corporate tax rate, a potential windfall of \$2.7 billion for taxpayers would result if they were not taxed on these potential amortization deductions.¹⁴² Although it is not clear by what amount taxpayers would benefit if settlements were reached, whatever the settlement policy, it will have major implications for the Treasury.¹⁴³ Hence, whatever strategy the Service pursues with regard to reconciling amortization deductions under prior law, significant controversy will likely result.

Some taxpayers will also be subjected to adverse consequences as a result of the revision in section 197.¹⁴⁴ Taxpayers claimed deductions had calculated useful lives that ranged from 6.3 to 10.6 years for \$8 billion worth of disputed intangibles.¹⁴⁵ The median of these two extremes is 8.4 years, which is significantly less than the fifteen-year amortization period required by revised section 197.¹⁴⁶ Taxpayers receiving deductions will thus be required to spread the useful lives of their assets over longer periods, for purposes of depreciation, entitling them to a smaller depreciation deduction each year than they would have without the fifteen-year statutorily imposed requirement. Some taxpayers would arguably prefer the facts and circumstances approach that existed prior to revised section 197 so that they could use shorter useful lives and correspondingly greater annual depreciation on their intangible assets.

A possible long-term negative consequence of new section 197 is that it might encourage leveraged buyouts.¹⁴⁷ Because goodwill is the value paid for a company over and above the value of the tangible assets, companies might buy other companies at artificially high prices and allocate the excess

¹⁴⁰ H.R. CONF. REP. NO. 103-213, *supra* note 139, reprinted in 1993 U.S.C.C.A.N. at 1385. On this line of thought generally, see Brode, *supra* note 111, at 1019-20.

¹⁴¹ Brode, *supra* note 111, at 1019 n.38.

¹⁴² *Id.*

¹⁴³ *See id.*

¹⁴⁴ *Id.* at 1019-20.

¹⁴⁵ *Id.* at 1019.

¹⁴⁶ *Id.* at 1019.

¹⁴⁷ *See* Middleton, *supra* note 112, at 826 (arguing that prospective tax savings will blunt criticism that the intangibles bill will encourage leveraged buyouts).

of the value of the tangible assets to goodwill. These companies would then take huge depreciation deductions on the acquired goodwill, costing the government a great deal of revenue.¹⁴⁸ This argument is hypothetical at present, but the possible causal link between new section 197 and corporate takeovers will have to be watched closely.

A more theoretical concern is inextricably linked to the puzzling concept of goodwill. Before understanding this concern, it is necessary to explain "depreciation." The purpose of the depreciation allowance is to permit taxpayers to recover their capital investments in wasting assets as a charge against income earned by the assets.¹⁴⁹ By allowing for depreciation deductions, taxpayers are not taxed on the return of their capital.¹⁵⁰ The depreciation deduction is based on the fact that most types of property reach a point where they are no longer useful because of wear and tear through time.¹⁵¹

Recall that goodwill is characterized as the expectancy of continued customer patronage.¹⁵² Goodwill is based upon a continuous course of dealing that is expected to continue over an indefinite period of time.¹⁵³ Traditionally goodwill was not depreciable because its useful life cannot be ascertained with reasonable certainty.¹⁵⁴

In *Newark Morning Ledger Co. v. United States*,¹⁵⁵ the Court stated that any asset that has a limited useful life and an ascertainable value is, by definition, not goodwill.¹⁵⁶ The *Newark Morning Ledger* decision did nothing to alter this traditional characterization of goodwill. Goodwill is not the type of thing, like a piece of equipment, whose value necessarily diminishes over time.

¹⁴⁸ House members in the Conservative Democratic Forum sent a letter to other House members claiming that House Bill 13 (the predecessor bill to revised section 197) would subsidize "new mergers and acquisitions activity by allowing one company to buy another at inflated prices and take huge deductions at taxpayer expense." David S. Hilzenrath, *Congress Targets Clinton Tax Plan: Major Revisions Are Expected*, WASH. POST, Apr. 21, 1993, at F3.

¹⁴⁹ 5 MERTENS, *supra* note 4, at § 23A.03.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² See *supra* note 29 and accompanying text.

¹⁵³ Dubin, *supra* note 18, at 931.

¹⁵⁴ 5 MERTENS, *supra* note 4, at § 23A.03.

¹⁵⁵ 113 S. Ct. 1670, 1680 (1993).

¹⁵⁶ *Id.* at 1680 n.13. For a more detailed discussion of this point, see *supra* text accompanying notes 93-95.

Insofar as revised Code section 197 allows for the depreciation or amortization of goodwill over a fifteen-year period,¹⁵⁷ it fails to adhere to the general purpose behind the depreciation deduction. To permit taxpayers to recover their capital investments through depreciation deductions on assets that, by their very nature, do not diminish in value through time, is disingenuous. Applying the term "depreciation" to "goodwill" simply violates the traditional meanings of these terms. The revision to section 197 appears to have been dictated by practical rather than theoretical concerns.

VIII. CONCLUSION

The depreciation of intangible assets has caused a great deal of controversy between taxpayers and the Service. Although taxpayers argued that these assets were depreciable, the Service argued that these assets were indistinguishable from goodwill and thus nondepreciable. Applying the two-part *Houston Chronicle* test, courts focused on the particular facts and circumstances of each case, often reaching apparently inconsistent results. In *Newark Morning Ledger*, the Supreme Court clarified the issue, but still left some uncertainty regarding the precedential value of its decision to future intangibles cases.

Section 197 of the Internal Revenue Code makes some strides in resolving the dispute, because it creates no distinction between goodwill and intangible assets for tax purposes. Providing for a uniform fifteen-year depreciation period for goodwill and other intangible assets, the Code arguably imposes certainty and predictability, and encourages the equal treatment of similarly situated taxpayers.

Although section 197 offers a number of practical advantages, it suffers from a major theoretical drawback. Having no support in either historical case law or the Supreme Court's recent decision in *Newark Morning Ledger Co.* for allowing goodwill to be depreciated over a fifteen-year period, Congress dramatically changed the landscape regarding the depreciation of intangibles. The theoretical inconsistency in Congress' revision, although probably outweighed by practical advantages, must be acknowledged because of the wide and long-term impact of section 197.

¹⁵⁷ I.R.C. § 197(a), (d) (West Supp. 1994).

